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The QE Trap

Quantitative easing (QE) is the latest central bank fad. After years of QE by the US Federal Reserve, the Bank of Japan, the Bank of China and the European Central Bank have adopted their versions of the policy. The immediate effect was a depreciation of each exchange rate and an increase in some measures of monetary growth. I will discuss the US experience and ECB problems here.

Putting aside the hype, adopting the QE policy consists of two principal changes. First, the central bank no longer limits its purchases to very short-term, safe assets. It buys other instruments, ones that it formerly spurned as too risky for central banks. Second, the central bank commits to a large increase in bank reserves.

The Federal Reserve's initial QE purchases in 2008 successfully provided enough reserves to prevent a major banking crisis. And by lending dollars to foreign central banks, the program eased credit market strains in many other countries. Preventing a possible major crisis was a success for the Fed and for central banking in general.

After that, the Fed made some major errors. It continued to supply additional reserves to hold rates near zero, \$4 trillion in all. Most of the reserves supplied after 2009 now sit idle on bank balance sheets, where they earn about 0.25 percent interest a year. Current idle excess bank reserves are \$2.4 trillion. The Fed has never given a plausible explanation of how it will prevent the banks from using the reserves to expand credit and print money in the future or how it will withdraw the reserves without causing a recession.

The Fed's big mistake was to allow the enormous, unprecedented reserve accumulation. It failed to recognize that the main problems of the United States are not monetary. As such, they cannot be improved by supplying an unprecedented amount of reserves.

The first signal indicating that the economic problems in the United States were not monetary came in late 2009. By that time, it was clear that adding reserves would not increase borrowing because most of the additional reserves were idle – excess reserves. The economic problems were real, as opposed to monetary, caused mainly by the Obama administration. The administration issued many costly new regulations, favored higher taxes and brought costly lawsuits. Soon after, *The Economist* ran a cover story asserting that most of the charges were vague, but firms nonetheless settled by paying fines instead of going to trial.¹

A second clear signal that the problems were mainly not monetary came when business investment failed to recover. Monetary policy reaches the real economy principally by raising prices of assets like houses and common stock. The rise in these asset prices revives economic activity by making new houses and new capital investment cheap relative to the higher prices of existing assets. However, the low demand for new houses and the weak business investment showed that the monetary policy was not working. The Fed ignored these signals because it ignores money and credit.

QE built in many problems for the future. One of the biggest is that the Fed enabled the Treasury to finance enormous deficits at exceptionally low interest rates. Large losses await those who hold the bonds when rates rise, as they will. A second problem is that pensioners took on greater risk to maintain earnings. Instead of rolling over bank CDs, they invested in higher yielding, riskier assets. They, too, will take large losses. A major readjustment is in the

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¹ The criminalisation of American business, in: *The Economist*, 28 August 2014.

offing. When interest rates return to past levels, or possibly climb even higher, many additional problems will become visible.

Among the main cheerleaders for the QE program are stock market traders and speculators who made large profits when stock prices rose. They, like the Fed, put too much emphasis on near-term events and too little on longer-term consequences. Their wealth gains encouraged their European counterparts to call for the ECB to implement its own QE program. I believe it will have positive near-term effects, in part by devaluing the euro.

However, QE cannot solve the main problems of the eurozone. A modern fixed exchange rate system requires countries to permit real wages to adjust in ways that are broadly compatible with changes in other countries in the system. The evidence is there for all willing to see it. That is what Ireland and Spain did – they deflated. It was painful, but it made their production costs compatible with costs in Germany, the Netherlands and Finland.

The Schröder government reduced German labor costs prior to the financial crisis, which gave the German economy competitive advantages during Chancellor Merkel's term. In a fixed exchange rate system, the other eurozone members must do the same or, alternatively, they must get Germany to reverse its successful policy by increasing labor costs. After her reelection, Chancellor Merkel made some small moves in that direction, but the gap between Germany and France (not to mention the peripheral eurozone countries) remains large.

Complaining about “austerity” evades the point. When countries joined the fixed exchange rate system, knowingly or not, they committed to periodic adjustments of real wages to smooth differences in production costs. Instead of making those changes in good times, several countries spent heavily and paid for the spending by borrowing at the reduced interest rates that accompanied the founding of the ECB.

Greece is one of the worst examples. Its wages and benefits rose far above its productivity. Its debt spiked. Before the current crisis, Greece neglected a central law of economics: Over time real wages must adjust to productivity. In practice, real wages can differ from productivity for a time because productivity is not easily measured. But if real wages remain disconnected from productivity, profits fall, firms go out of business and owners find other uses for their capital, including foreign investment. Indeed, the eurozone's fixed exchange rate system encourages this by removing the exchange rate risk of investment in other member countries.

France and Italy have many political roadblocks in the way of real wage adjustment. Both countries have stubborn, recalcitrant labor unions that oppose real wage reductions and losses of benefits, including generous pensions. They resist bringing real wages back in line with worker productivity. This is understandable, but there are no better alternatives that both end this crisis and avoid a repeat of current problems in the future.

The French and Italian governments can hope that the ECB's QE program will ignite enough German inflation to raise German real labor costs, thereby sparing them the need to deflate. I do not think that will happen. It requires much more inflation in Germany and other creditor countries than in France and Italy.

The euro's current problems will return again and again until either the system breaks up or the members allow compatible adjustment of unit labor costs. European voters tell pollsters that they want their country to remain in the eurozone. If that is their overwhelming choice, authorities should explain to them what that entails. At the top of the list must be agreement to reduce the overly generous benefits that the countries' labor unions have obtained for workers.